Contemporary Issues in Finance
Pension scheme deficits

Martin Upton

The issue about pension fund deficits has been well explored in the press in recent years. It's a product of the low investment returns which we've seen in recent years and the growing longevity of the population. Marcus, what do you see as the future, when it comes to sorting out these problems?

Marcus Davidson

I think, first of all, we have to be clear what the problem is and much of the public debate is about the wrong problem or a non-problem. We've grown used to talking about pensions funds - or pension schemes, rather - as being either unfunded or funded. In an unfunded scheme no provision is made to pay pensions in the future but pensions are simply paid out of current earnings in the case of a company, or current tax in the case of a government and its pensioners. A funded scheme, we've been told, is a more prudent way of providing for pensions, where a company or employer builds up a fund of investments which will yield a return in the future to pay pensions. Now, at a micro-economic level of the company that makes a certain sense. It means the employee is not dependent on the company directly for future pensions so, if the company goes bust, there'll still be a pool of investments out of which the pension will be paid. At the macro-economic level when you, as it were, notionally consolidate all the employers in the country together, then this protection disappears because they've all promised to pay each other's current employees future pensions out of their own future earnings. That is, the pension fund consists of shares; the shares will pay dividends. So, they've all promised to pay dividends in the future to pay each other's pensioners. Now, when you, as it were, fictitiously consolidate all the employers in the country, then the difference between the funded and the unfunded scheme evaporates. You're up against the central fact which is that, funded or unfunded, current pensions have to be paid out of the economy's current output. So, the central problems is that the expected output of the economy in, let's say 2026 – in twenty years time – appears to be insufficient to meet what are projected to be the 2026 claims of providers of capital, current employees and today's pensioners. And something somewhere has to give unless, of course, measures are taken to improve, to increase, the level of productive output. So, just saving more today doesn't magically solve the pensions problem; the only thing which solves the pensions problem is investing today in future production – in expanding the productive base of the economy – and to my knowledge very little of the debate has focussed on that central problem.

Graham Honeybourne

I was very intrigued to hear Marcus' views there; he hadn't shared those with me before. I have just flagged something there, because the fundamentals of most company pensions schemes now and most insurance schemes is to set up liability management structures and transfer a vast amount of the assets to meet the minimum requirements of the fund into fixed income assets, particularly government assets; and we've seen that in the Boots case, where Boots moved a substantial portion into bonds. It also helped them de-risk their own balance sheet, and many companies are taking this approach now, to reduce the volatility of impact. But they're buying fixed income and they're buying state bonds; they're not really investing in the future productivity of our nation. They are buying government bonds to pay current government deficits. In addition to that I also think that a large portion of the way that the calculation is done of the pension accruals in pension funds, they use current variables and forecast the future return rates and, as rates have fallen, the need – or the deficit in the funds - has increased and Marcus has referred already to about the memory of high return rates. I think companies were very fortunate to have high excess values in their funds in the early 90s and became heavily reliant on equities and, as equities have switched over in the last few years, that has burnt through into the pension funds and that needs to be rebuilt and it will have to be built out of earnings and product value creation; and that will put a drain, certainly on all the countries in the European union with these heavy older populations. And it will restrict our growth.